

C. THE COLLEGE AND UNIVERSITY EXAMINATION GUIDELINES

**by
Robert Louthian and Robert Harper**

1. Introduction

Colleges and universities have become more complex from both an operational and a structural standpoint. Some of today's university systems rank among the largest of tax-exempt organizations, and require, in their examination, an increased level of audit sophistication and coordinated examination. In an effort to provide guidance to Exempt Organization examiners on issues in these cases, the Service has drafted proposed examination guidelines. The proposed guidelines appeared in the Internal Revenue Bulletin (1993-2 I.R.B., p. 39 *et. seq.*) on January 11, 1993. Public comments were solicited and a public hearing will be held on the guidelines in mid-1993.

At the time of writing this article, the public hearing on the guidelines is two months away. Because the guidelines will be revised as a result of public comments at that hearing, this article will discuss issue areas which the guidelines address rather than the specific numbered sections within the proposed guidelines.

The publication of guidelines has taken on new significance. Although still intended primarily to assist Exempt Organization agents in conducting examinations, their impact is now much broader. Because of their public nature, guidelines serve a dual role. They educate exempt organizations as to what information the Service is interested in examining, and they provide guidance to examining agents. The guidelines address principal areas of concern, but certainly not all areas of concern. Therefore, the guidelines can not be considered a comprehensive list of all potential tax issues that may be raised in an audit.

The guidelines can be roughly broken down into three parts. The first part consists of background and general information regarding colleges and universities. The second part deals with documentation. The third part deals with various issues.

2. Background and General Information

The most important paragraph in the guidelines, the one that sets the tone for the pages that follow, is the first paragraph. This paragraph states:

"These guidelines provide a detailed description of various areas that may warrant review in an examination. However, they are not intended to require examiners to exhaustively review all areas described in every examination of a college or university. The scope and depth of any particular examination will depend on the issues raised. Examiners or case managers should use their professional judgment to determine the scope and depth of each examination." (Emphasis added).

The guidelines should not be interpreted as requiring an agent to secure every document or explore every issue mentioned in the guidelines. Instead, the guidelines merely provide an outline from which to work and a listing of various items that may assist the agent. It is expected that agents will exercise judgment and perform their examinations using customary procedures involving statistical sampling of documents, spot checks, and random selections from voluminous records.

3. Documentation

The guidelines suggest that examiners obtain and review various items such as school bulletins, telephone directories, minutes of meetings, etc. These documents are listed as potential sources of information regarding the structure, both formal and informal, of the university. The information listed in the guidelines should be relatively easy for the university to supply. Given the amount of information likely to be available to the agent, sampling is encouraged.

For colleges and universities that conduct federally sponsored research, the information required by OMB Circular A-21 offers the examiner valuable insight into the institution's organizational structure, accounting system, adequacy of internal controls (reporting, accounting, cash management and procurement), as well as other relevant issues (e.g., reasonableness of compensation, fringe benefits, unrelated trade or business, illegal activities). The total cost that the federal government pays an institution for sponsored research equals the institution's allowable direct costs plus the allocable portion of allowable indirect costs, reduced by any applicable credits. The institution is required to prepare and submit a cost proposal package to the specified federal agency. The cost proposal package, a public document, contains much useful information including: (i) the indirect cost proposal, including detailed schedules on the composition and allocation of each indirect cost pool; (ii) audited financial statements; (iii) a detailed reconciliation between the indirect cost proposal and the audited financial

statements, showing each reclassification and adjustment to the financial statement accounts; and, (iv) in some cases, an explanation of significant increases in individual rate components and other information requested by the cost negotiator.

Income, expense and balance sheet analysis can yield many potential examination issues. Some sources of income may indicate potential issues reflecting on exempt status. These areas include: (a) business conducted with the general public; (b) use of exempt organization assets in activities not in furtherance of exempt purposes; (c) impermissible insider benefits resulting from inappropriate investments (*e.g.*, less than arm's length transactions, churning of investment accounts for commission profits, placing of assets for investment with insiders, and placing of investments in risky or speculative ventures); (d) joint ventures with other exempts or for profit entities; and, (e) potential sources of unrelated business taxable income. On the expenditure side, potential examination issues will often involve inappropriate or improper expenditures not in furtherance of any exempt activity, and various forms of disguised compensation, including those involving discretionary accounts. Balance sheet analysis can be helpful in determining whether certain restricted sources of income exist; whether the restricted funds are being appropriately utilized; and, whether the fund management practices of the institution involve risky or speculative investments which may constitute either private benefit or inurement.

Many universities' financial statements include a statement of cash flows. See Financial Accounting Standards Board Statement No. 95. This may eventually be required in all universities' financial statements. The statement of cash flows offers valuable insights into a university's activities (*e.g.*, the effects of cash and noncash investing or differences between net income and cash receipts/payments) revealing, for example, large cash investments in a joint venture, loans, major acquisitions or dispositions. The examiner should analyze the statement of cash flows (or, if a condensed statement of cash flows is used, a more detailed cash flows statement). If appropriate, the examiner should request the underlying work papers. See IRM 7(10)44.(10)4.

The purpose of looking at inside and outside documentation is to develop possible examination issues, that is, areas of inquiry where the institution may be deficient in meeting the legal requirements for exemption, may have unreported unrelated business taxable income, or may not be meeting excise or employment tax requirements.

4. Specific Issues

This part will not address every issue discussed in the guidelines. Instead, it will focus on those issues that the Service perceives as common throughout the college and university universe.

A. Employment Tax and Fringe Benefits

The first issues dealt with at any length in the guidelines are employment tax and fringe benefits issues. Although there are several areas where employment tax issues arise, there are three significant problems peculiar to the college and university setting. For a general discussion of exempt organizations and employment taxes, see Exempt Organizations Continuing Professional Educational Technical Instruction Program for 1992, (hereinafter "EO CPE 92") p. 284.

First, improper classification of workers as independent contractors is an issue routinely identified during an examination. In the college and university area the issue may arise, for example, when a college treats an adjunct professor as an independent contractor. The determination as to whether an adjunct professor should be classified as an employee is to be made using the twenty common law factors indicating an employment relationship. For a list of the 20 common law factors, see Rev. Rul. 87-41, 1987-1 C.B. 296.

Second, the failure to classify certain students as employees is another area where colleges and universities often err. The employment tax provisions provide limited exclusions from the definitions of employment and wages. IRC 3121(b)(10) excludes from FICA services performed by a student in the employ of a school, college, university, or an IRC 509(a)(3) organization, provided the student is enrolled and regularly attending classes at the institution, and, the student is performing services "as an incident to" a course of study. For a more in depth discussion of the treatment of students and the exclusion of certain wages from FICA, see EO CPE 92 at 315.

Finally, the failure to report the value of fringe benefits is a recurrent problem. A fringe benefit is any property or service that an employee receives from the college or university in lieu of, or in addition to, regular taxable wages. If a benefit is not specifically excluded from gross income by the Code (*e.g.*, IRC 79, 105, 106, 107, 117(d), 119, 129, and 132), its value must be treated as compensation and reported as wages in the appropriate box on the employee's Form W-2. Reg. 1.61-21(a)(3). The term "employee" generally includes any

person performing services in connection with which a fringe benefit is furnished. Thus, the person to whom a fringe benefit is taxable need not be an employee of the provider of the fringe benefit, but may be, for example, a partner, director, or an independent contractor. Reg. 1.61-21(a)(4)(ii).

In the examination guidelines, you will note that it is not necessary that the benefit be furnished directly to the employee by the college or university, as long as the benefit is provided in connection with the performance of services for the university. For example, the use of an automobile provided to a college or university employee by an athletic booster club or an automobile dealer may be treated as a fringe benefit provided by the university. Some commentators have indicated that it is difficult, if not impossible, for the college or university to know of fringe benefits provided by third parties to employees. To the extent that these fringe benefits are not channelled through the institution, we would certainly agree. However, many such third party fringe benefits do come by virtue of the position occupied by the employee at the university. Further, many institutions require employee disclosure of fringe benefits that may be directly provided in order to insure that no conflicts of interest exist. To the extent the institution is made aware of the benefit, and the benefit is provided by virtue of employment, the employer is under a duty to include such benefits in the employee's gross income and treat it as wages on the Form W-2.

In analyzing fringe benefits, examiners should utilize the following approach:

- (1) Identify the fringe benefit and assume that it is taxable under IRC 61,
- (2) Check to see whether any statutory exclusions apply,
- (3) If no exclusions apply, include the benefit in the employee's gross income.

B. Retirement and Pension Plans

A large issue, not addressed in the guidelines, has already been resolved in this area by virtue of section 1012(c)(4) of the Tax Reform Act of 1986 (P.L. 99-514 (October 22, 1986)). That Act added IRC 501(m) of the Code which, briefly, prohibits the exempt status under IRC 501(c)(3) and IRC 501(c)(4) of certain organizations providing commercial-type insurance as a substantial part of

their activities. The exception in section 1012(c)(4) of the 1986 Act legislatively affirms the exempt status of a number of organizations, among them, Teachers Insurance and Annuity Association and College Retirement Equities Fund, more commonly known as TIAA/CREF. TIAA/CREF provides employees of educational institutions retirement plans consisting of individual annuity contracts, and on a more limited basis, major medical, total disability, and life insurance benefits. This entity will be found operating its pre-ERISA pension plans in virtually every college and university in the United States.

The guidelines recognize that other pension plans may also exist at some colleges and universities. Issues developed in those plans should be referred to employee plan specialists as indicated in the guidelines.

C. Contributions/Fundraising/Debt Structure

These items are grouped together in the guidelines because the Service perceives their relatedness from the standpoint of audit issues. It is fair to say that the costs associated with the operation of the typical college or university are not covered by the tuition charged or the endowment maintained by the institution. This means that the college or university must constantly seek outside sources of income, including income in the form of gifts. Further, depending upon particular cash flow situations, the incurrence of debt may be viewed as a regular occurrence.

Potential abuses of exempt organization status may exist as a result of this continuing process. In particular, the examiner should be alert to possible quid pro quo arrangements in the making of gifts that suggest that more than mere public acknowledgement is being received in exchange for the gift. The examiner should also be alert to the possibility of spurious, worthless, or overvalued gifts. The guidelines provide that borrowing arrangements, both short and long-term, should also be scrutinized for unusual features that may suggest either inurement or private benefit. Finally, tax exempt bond issues need to be considered where the institution has engaged in such activity. Of special concern in this area is the issue of impermissible private use of bond financed facilities. An extensive list of documentation with regard to bond issues is set forth in these guidelines which may be of relevance in determining impermissible private use. (Note: not all of these documents may be needed.) Assistance from the National Office should also be requested, when necessary, in this area.

D. Research and Contracts

The main focus of the research section of the guidelines is whether the conduct of a research activity by a college or university may result in impermissible private benefit. This area is an excellent example of a situation where the law hasn't changed, but the facts have become more complex. The college research environment has been undergoing change and the problem of private benefit in the university research context has taken on new significance. In the past, university scientists were not interested in the income potential of their research because there was no income potential identifiable at the start of the project. Today, however, the distinction between research and commercial exploitation has become blurred. The research process has quickened and now universities and university researchers can see future profits in their research before the project has begun.

Often, a university will allow a particular researcher to retain the rights to his or her research. Under the scientific research regulations, research will be considered in the public interest even though an individual may retain the exclusive right to the use of a patent, copyright, process, or formula if the granting of such exclusive right is the only practical manner in which the patent, copyright, process or formula can be utilized to benefit the public, and only if it is carried on for a purpose described in Reg. 1.501(c)(3)-1(d)(5)(iii)(c). These purposes include research for the purpose of aiding in the scientific education of college or university students.

A university that engages in large-scale research activities should have a code of ethics in place regarding the conduct of research where an employee retains the rights to the results. An agent should ascertain whether such a code exists and whether the university adheres to such policies. If no code of ethics exists and upon reviewing the research contracts the agent determines that private persons or employees are retaining the rights to the research product, the university should explain why the transfer to a private individual of a product whose value was enhanced (if not created) by tax-exempt funds, does not result in impermissible private benefit.

Related to the question of private benefit is the establishment of technology transfer organizations to facilitate the transfer of college-developed and licensed technology. These technology transfer organizations as well as the actual technology transfer agreements should be analyzed for impermissible private benefit.

The transfer agreements we see today are far more complex than the ones

we were seeing just three years ago. Universities realize the intrinsic value of their intellectual properties and have begun to set up various relationships with commercial industries to transfer the technology to the private commercial sector. These relationships have served to accelerate the transfer of the technology, but have also raised questions about potential conflicts between academic research and the pursuit of profits or the private benefit of the researcher at the expense of education. Although there is no control test for technology transfer organizations, the amount of control that a university retains over these organizations may be indicative of impermissible private benefit. If the university control is less than a majority interest, the agreement and the organization may deserve heightened scrutiny.

IRC 512(b)(8) excludes from the definition of unrelated business taxable income (UBTI), in the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income. The term "research" does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations. Reg. 1.512(b)-1(f)(4).

Rev. Rul. 68-373, 1968-2 C.B. 206, holds that a non-profit organization primarily engaged in testing drugs for commercial pharmaceutical companies pursuant to the companies' marketing applications to the Food and Drug Administration did not qualify for exemption. The ruling states that the clinical testing of a drug for safety and efficiency in order to enable the manufacturer to meet FDA requirements for marketing is merely a service performed for the manufacturer. There is, therefore, a presumption that a project is "ordinary testing" if the work is performed to satisfy a federal or state regulation requiring such an evaluation before a product may be marketed.

In G.C.M. 39196 (September 21, 1983), Chief Counsel discussed the congressional intent behind IRC 512(b)(8). The G.C.M. states that Congress, in excluding university research from taxation, anticipated that the purpose of such research, as reflected in the regulations, would be related to the primary exempt purpose of a university (*i.e.*, teaching students). If such research led to private contracts, the university would not be required to separate these out for unrelated income tax purposes. To make the opposite assumption, that Congress was not concerned with whether the research was related to the university's exempt function, would allow any commercial research organization to have all of its income from research excluded merely through affiliation, however tangential, with a university. This was not a result that Congress could have intended.

Admittedly, the organization in Rev. Rul. 68-373 was not a college or a university, a group which has been given a much larger exclusion from UBTI for research activities. However, the regulations clearly state that "research" does not include activities carried on as an incident to commercial operations. While Congress clearly sought to expand the types of research in which a college or university could engage tax-free, it did not grant the research departments of colleges and universities carte blanche for all activities (*e.g.*, market testing) that the university may label, "research."

Thus, a distinction must be made between "research," which is excluded under IRC 512(b)(8), and "testing," which is subject to the more normal unrelated business income tax rules. The distinction between market testing and research is a difficult line to draw. Certain factors, if present, may tend to tilt the decision toward one side or the other. The following factors may be an indication that the university is engaged in testing rather than research: (1) the product with which the university is working requires federal or state government approval before it may be marketed; (2) the research sponsor designs the protocol with little or no input from the college or university; and, (3) publication of the results is delayed for an unreasonable time and thus not entitled to the benefit of the exclusion. This is not an exhaustive list. Likewise, even if a research project meets all three of the above criteria, it does not mean that the activity is market testing rather than research.

E. Scholarships and Fellowships

Two issues are addressed by the guidelines: first, whether and to what extent the scholarship or fellowship is excludable from taxable income by the recipient; second, whether in the provision of the scholarship or fellowship there are any restrictions that are contrary to public policy. As to the first issue, a number of suggestions are made with regard to allocation of the scholarship between excluded amounts and taxable compensatory amounts and the documentation appropriate to support these allocations. On the second issue, restrictions on scholarships and fellowships contrary to public policy are described and certain factual patterns indicative of improper restrictions are suggested as worthy of development as potential examination issues.

F. Legislative and Political Expenses

This section of the guidelines makes the point that certain legislative and

political activities, may in certain instances be conducted at the college or university, but not by the college or university without affecting the institution's exempt status. It is essentially a factual determination which requires the examiner to inquire into the policies of the college or university in opening up the institution to outside speakers in accordance with its educational mission and requires the examiner to determine whether on-campus activities are carried on in accordance with those policies. (This assumes, of course, that the policy itself is in accord with the requirements of IRC 501(c)(3)). Official lobbying is also a concern of this section. Lobbying beyond the institution's self-defense interests gives rise to a potential audit issue.

G. College and University Bookstores

What can a college sell to its students or the general public in its bookstores and not fear incurring the unrelated business income tax? The question has been with us for a long as time. Textbooks required for class? No problem, since textbooks are substantially related to the exempt purposes. What about a computer? Does it matter if the computer is required for a class? What about software for the computer? What if the software is for a computer game?

The sale of a computer to a student will probably be considered to be substantially related to the exempt purposes of the college. Now, let's change the facts slightly. What about the sale of three identical PCs to a student? Suppose we have a situation where a university bookstore becomes the low-cost supplier of computer hardware in a geographic area and students start buying up the computers for friends and family?

The origin of the problem can be traced to the convenience exception of IRC 513(a)(2). The Service position on whether the sale of an item to a student meets the convenience exception is set out in G.C.M. 35811 (May 7, 1974). In G.C.M. 35811, Chief Counsel made the following conclusions:

- (1) Phonograph records and tapes sold in college bookstores to students should, like books, be treated as related items.
- (2) In general, related items do not include items having an ordinary useful life longer than one year, except books, records, tapes, typewriters, pens, notebooks, and similar items.
- (3) As a general rule, and in the absence of clearly established special

circumstances (such as in the case of a bookstore on a campus located a considerable distance from any commercial facilities) items not directly related to the accomplishment of the educational purposes of a college, and having a useful life of more than one year (such as radios, television sets, refrigerators, cameras, jewelry and clothing other than sundry items like hosiery, handkerchiefs, sweaters, sweatshirts, school uniforms, and novelty items) will not be considered items sold for the convenience of students within the meaning of IRC 513(a)(2).

(4) Novelty items (such as jewelry, beer mugs, pillows, etc. imprinted with the school name or seal), incidental items of wearing apparel (such as school uniforms, sweaters, hosiery, handkerchiefs, etc.), and sundry items of low cost and recurrent demand (such as newspapers, magazines, candy, cigarettes, film, etc.) will be considered as coming within the convenience rule of IRC 513(a)(2).

The above conclusions have been updated administratively to include the sales of compact discs and computers.

The guidelines also discuss university bookstore sales to the general public. These sales are not related to the exempt purposes of the University and will generate taxable income. The bookstore should maintain adequate records to determine whether sales were to a student or the general public.

H. Share-Crop Leasing

This recurring examination issue, described in the guidelines, involves the treatment of sums received by colleges and universities in share-crop lease arrangements. At issue is whether the amounts received by the institution may be described as rent and therefore excludible from the unrelated business income tax by virtue of IRC 512(b)(3). A number of factors and a method of analysis are provided in the guidelines in making this determination.

I. Other UBIT Considerations

This is a listing of issues and GCMs dealing with those issues. Again, the Service has included them in the guidelines because it deems it necessary to address them because of their recurring nature.

J. Related Entities

This part deals primarily with the idea that no one part of the university can be viewed (or examined) in isolation. An examination of the relationships between the various entities may yield potential examination issues.

5. Conclusion

This article has touched on only the major issues in the guidelines. The guidelines attempt to provide a comprehensive overview of this examination area and to address many issues in that area. Several areas of the guidelines are continuing to develop as this article is being written. As public comments are received, it can be anticipated that some issues and fact patterns will be refined. It should also be anticipated that the hearings to come will provide elaboration in some issue areas.